

Winter 2020/21

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Summary 2020

2020 will certainly be remembered for the lives that were lost and disrupted by the COVID-19 pandemic – it will live long in our memories. The economic turbulence was swift and unparalleled. Financial markets plummeted in March, only to recover and post all time highs by year-end. It was quite the journey.

The S&P/TSX Composite stock price index managed to gain 2.2% on the year, while the S&P 500 in the U.S. was up 16.3%, in USD. The Canadian dollar appreciated for the second year in a row, gaining almost 2%. The major European markets underperformed. The UK (FTSE 100) was down 14% and France (CAC 40), was down by 7%. The Europe Australasia & Far East (EAFE) index was up by 6.4% in Cdn dollars. China had a very good year with the Shanghai composite index (SSE) advancing by 14%, while Japan (Nikkei 225), advanced by 16%. The Emerging Market (EM) index posted a gain of 16.6%.

Commodity prices were extremely volatile in 2020 yet managed to end the year on a high note. Oil (WTI), closed the year at \$48.50 USD, having plunged briefly in March to a contract price below zero. Copper, leading the base metals, was up by 26%. Gold was steadier and finished the year up about 24% to close at \$1,891.

2020 was another good year for the bond markets as interest rates fell. The FTSE Overall Universe bond index was up 8.7%. The 10-year benchmark Canada bond yield finished the year at .67%, down one full percentage point. The preferred share market, while volatile, ended the year mostly unchanged earning their dividend yields.

The chart below shows the performance of the major Canadian and U.S. stock market indices; the S&P/TSX Comp and the S&P 500. The global indices, EAFE and EM are also shown. The U.S. market outperformed again in 2020.



Forecast for 2021

The consensus forecast for 2021 is for the successful rollout of vaccines and a return to some form of social and economic normalcy. The economy is expected to strengthen mainly because of pent-up demand. Both fiscal and monetary policy will remain accommodative. GDP growth, in the U.S., is likely to exceed 6% and the unemployment rate will fall closer to 5%. Some pundits are forecasting 2021 to mark the start of the next business cycle, lasting for several years. Modern Monetary Theory (MMT) will be adopted to both stabilize the cycle and to channel needed funds into infrastructure spending and other government programs. Inflation is nowhere on the radar screen and therefore interest rates are projected to stay low for many years to come. Financial markets are expected to perform well, along with Bitcoin, as investors savings are channeled into new cryptocurrency funds.



There are forecasts for the price of oil to rise as high as \$80 per barrel in 2021. Should this occur energy stocks would finally get some respect. Many predict the best performing “pandemic” sectors of 2020, i.e. Technology and HealthCare, will now underperform as the stock market broadens out and becomes more “inclusive”. Of course, there are also plenty of warnings of a stock market correction, ranging from 10 to 20%. Still, even with this volatility, the majority believe the stock market will be higher by year-end.

Reviewing the forecasts made one year ago for 2020, the accuracy rate was quite low. Forecasts are plagued by hindsight bias and influenced by current conditions. Conditions change. Entering 2021, financial markets are probably best characterized as “extremely optimistic with high valuations”. While this does not mean a significant stock market correction is imminent, with a high level of risk, volatility should certainly be expected.

Modern Monetary Theory

The appointment of former Federal Reserve Chair Janet Yellen as Treasury Secretary means that there will be greater support for Modern Monetary Theory (MMT), to prevent the economy from stumbling. MMT will directly fund government fiscal spending and is seen to be more equitable as public money will be going to the “people”. This is different from Quantitative Easing (QE), which had limited success and has been criticized for increasing the inequality gap, mainly by supporting Wall Street.

Monetary policy is likely less effective with interest rates at historic lows. Lower interest rates have encouraged higher debt growth resulting in greater instability in the financial system.

Under MMT, the Treasury will send cheques directly to consumers and companies who will then spend it in the real economy. Incredulous as this may seem, it is gaining acceptance as a potential policy tool in government circles.

Governments globally recognize the economy is still teetering on the edge of a recession. It will take time to return to full employment even if the rollout of vaccines is a complete success. Central bankers are acknowledging that monetary policy has its limits. Governments will be under pressure to step in with an expansionary fiscal policy that is more targeted and effective. Like it or not, MMT could be the solution.

The Great Rotation

The performance in the stock market has been led by “growth” stocks, namely the technology sector, while stocks categorized as “value” stocks have underperformed. This has been the case for many years and has accelerated this past year. Many market strategists have been predicting that a rotation into value stocks is long overdue. This is primarily based on the relative performance gap between the two. Growth stocks have climbed to valuation levels which are historically at an extreme high. Value stocks are not only cheaper, but also offer better safety and higher yields. The current climate has attracted investors to growth stocks. This could change in 2021 as the pandemic subsides and economic conditions return to normal.

Value stocks did begin to outperform in October, just before the U.S. election. That reversed when news of the vaccines broke in early November. From that point on the best performing part of the market has been in the smaller and medium sized companies. Additionally, the market for new Initial Public Offerings (IPO) and Special Purpose Acquisition Corporations (SPAC) has been overwhelming as investors pile in and rotate into these new investments, perhaps diversifying away from the big established technology names.

There are many “value” managers that have already rotated to some degree and taken a defensive strategy. Last year, GMO, a
(continued on page 3)

The Great Rotation (cont'd from page 2)

major fund manager co-founded by Jeremy Grantham, reduced the stock exposure of their main flagship fund, the Benchmark-Free Allocation Fund, to around 25 percent. They have significantly underperformed. Grantham has a reputation for accurately predicting three major stock market “bubbles” over his 40-year career. He correctly predicted the Japanese Nikkei stock market bubble in the late 1980s, the dot com bubble in 2000, and the financial crisis in 2008/09 - although he was always a bit early in his timing.

Grantham's philosophy as a long-term value investor is practical and focused on the 'reversion to the mean' principle. Quite simply, all markets get carried away and eventually revert back to their mean historical price levels. The euphoria in a bull market cause markets to overshoot on the upside. Likewise, in the panic of a bear market the stock market will overshoot to the downside. Valuable lessons.

Debt Anxieties

The mountain of debt continues to grow. Budget deficits have become a permanent part of the landscape. Every economic cycle the accumulated debt grows larger and larger. The pandemic has only worsened matters fiscally with total U.S. Federal debt jumping in 2020 by \$4 Trillion to reach almost \$28 Trillion. In Canada, the combined Federal and Provincial debt outstanding has jumped to about \$2 Trillion.

In the private markets, a rising level of debt usually signifies greater risk and attracts the scrutiny of financial analysts. Banks and investment dealers downgrade the debt of a company with poorer financials and investors demand a higher bond yield for the added risk they are taking. For federal or provincial bonds, it

is another matter altogether. Governments borrow decade after decade with no intention of paying it back. Governments routinely prop up the financial markets. There appears to be an endless ability for governments to borrow and spend without consequences. It does not seem rational for an investor to lend the government their savings for a 1% annual return. Investors in Europe and Japan should be so fortunate, government bonds there are yielding negative interest rates. Maybe this is just the new normal and we are the only ones with any anxieties over the growing debt. Economists warn of possible dislocations in the bond markets, or in currency markets, or that inflation will return with a vengeance. So far so good. We will keep on watching.

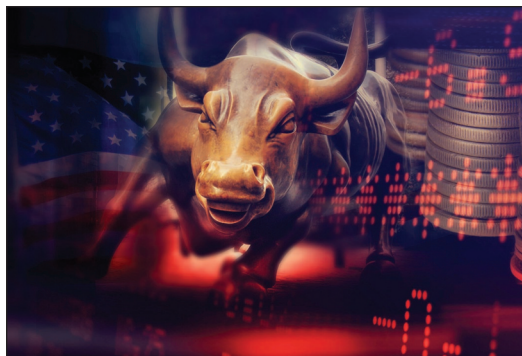
A Bullish Narrative

In his latest book, *Narrative Economics: How Stories Go Viral and Drive Major Economic Events*, Robert J. Shiller, Professor of Economics at Yale University, outlines the case that narratives, or stories, are significant drivers of economic events.

In his book Shiller writes, “The human brain has always been highly tuned towards narratives, whether factual or not, to justify ongoing actions, even such basic actions as spending and investing. Stories motivate and connect activities to deeply felt values and needs. Narratives “go viral” and spread far, even worldwide, with economic impact”.

We see this playing out in financial markets, particularly today as narratives drive stock prices higher and higher. Deep analytical research or economic fundamental truths are irrelevant. Tesla, Virgin Galactic, or any number of stocks with a good underlying “story” continue to show positive momentum. A new generation of day traders on social media are also behind many of the narratives. Flush with government stimulus cheques they have become a new force in financial markets.

The main bullish narrative investors continue to endorse is that the Federal Reserve is “stimulating” or “printing money”. The Fed has your back. This is the narrative driving investors to speculate. As a result, our perspective has changed. As long as central banks continue to support and encourage risk taking by stimulating and keeping interest rates low, the stock markets may do fine and keep surprising us by their resilience.

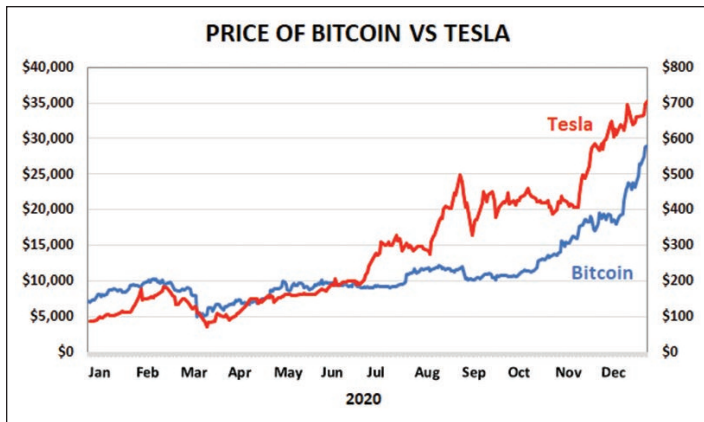


There is also a bullish narrative surrounding the new post-pandemic world that awaits us. Pent up consumer spending and even perhaps a behavioural change much like what occurred after the Spanish Flu of 1918/19. The roaring 2020's awaits us as soon as the lockdowns are lifted, and we are free to socialize again. Whether comparable or not to the 1920's, it makes for a good bullish story. (Note to history buffs – there was a war to end all

wars called WW1, this may have set the stage for the euphoria of the 1920's).

Bitcoin & Tesla

The adjacent chart shows the incredible price rise of both Bitcoin and Tesla in 2020. They best illustrate the euphoria underway in financial markets. Curiously, they were both worth around \$100 Billion at the start of the year and now command market values closing in on \$1 Trillion.



While completely different investments they are a product of excess liquidity made possible by modern central banking. However, in the case of Tesla, classic money creation by central banks helped fuel the rise of a stock with a great narrative. While for Bitcoin, it was the concern over the same money creation that drove investors into a new asset class, ostensibly for protection from the folly of central bankers. Liquidity makes for strange bedfellows.

We had always remained skeptical on Bitcoin and cryptocurrencies in general. It is not easy to comprehend, even for those with a computer programming background. There is no rational means to value it, or even how to properly define it, currency, or asset? We do now have a better understanding of the underlying infrastructure and how it all works. We have an appreciation for the high caliber and the great number of people who have committed themselves to all things crypto. In just the past year several high-profile investors and some established institutions have done their research and invested in Bitcoin. Investment bankers and fund managers have recently filed for regulatory approval of cryptocurrency exchange traded funds and other similar products.

In many respects Bitcoin is very similar to Tesla or even Gold. It is governed by supply and demand and is worth what someone else is willing to pay for it. Valuations and fundamental economic factors are taking a backseat to sentiment and confidence. Inflation expectations and technological changes are also driving the narrative. If investors are willing to give Tesla a \$1 Trillion dollar valuation, then why not Bitcoin. Investors today are flush with cash thanks to Uncle Sam, have little incentive or desire to buy bonds, and are willing to speculate. Time will tell whether Bitcoin will have staying power or whether it is just a fad. Importantly, and ironically, central bank policy will determine the fates of the Bitcoins and Teslas in the marketplace.

Portfolio Strategy

While we remain favourably disposed to financial markets we recognize the risks are also high. Holding cash and defensive assets is also recommended for several reasons. It will provide a cushion against market volatility. It allows us to reposition into the stock market and certain sectors at lower prices and therefore lower risk.

The pandemic has accelerated the usage of many technologies. A report from McKinsey, claims the adoption of e-commerce by businesses jumped forward by 10 years during the lockdowns last year. The true economic and social impact of this across various markets and industry sectors going forward is still unknown.

Companies will be increasing their spending budgets in 2021 to facilitate working from home. As the global economy recovers in 2021 and beyond, investments in technology such as online communications, e-commerce, and big data analysis will be a priority for businesses across all sectors and industries. This should drive markets higher over this next business cycle.

Strong global economic growth combined with record liquidity can be a powerful fuel for the market. This is also a scenario where we need to be concerned about inflation and interest

rates, but it would be an environment in which global stocks as an asset class are probably performing relatively well. A big question mark is what will happen if inflation and commodities prices get out of hand. We will be monitoring this closely in 2021.

As for the bond market, any signs of inflation will be a nightmare for longer term bonds. Importantly, bond yields have been artificially kept low and are completely mispriced if we get even a modest increase in inflation. Many fixed income analysts are of the opinion the 10-year US Treasury yield is already at least 100 basis points, or 1%, too low, given the strong economic conditions ahead.

Over the longer term we believe that it is important to constantly think of capital preservation and risk management. In the short term however, you always want to maximize or take advantage of a strong market and investor enthusiasm. Currently the majority of investors have a "Fear of Missing Out" which often supersedes common sense and logic. In balanced portfolio mandates we remain approximately 50/50 invested in stocks and bonds. It is a mix which we are comfortable with given current conditions.